

ECO 209Y
MACROECONOMIC THEORY AND POLICY

Term Test #2

LAST NAME _____

FIRST NAME _____

STUDENT NUMBER _____

INSTRUCTIONS:

1. The total time for this test is 1 hour and 45 minutes.
2. Aids allowed: a simple calculator.
3. Use pen instead of pencil.

DO NOT WRITE IN THIS SPACE

Part I _____/30

Part II _____/10

Part III 1. _____/10

2. _____/10

3. _____/10

4. _____/10

TOTAL _____/80

PART I (30 marks)

Instructions:

- Enter your answer to each question in the table below.
- Each correct answer is worth 2.5 marks. **Note that a deduction of 0.5 mark will be made for each incorrect answer.** Table cells left blank will receive a zero mark (i.e., no deduction).
- **Do NOT guess your answers!**

1	2	3	4	5	6	7	8	9	10	11	12

1. Consider the fixed-price model of a closed economy. If the demand for real balances increases at each level of the market rate of interest, which one of the following statements is correct?
 - A) The IS curve shifts up to the right and income increases.
 - B) The IS curve shifts down to the left and the LM curve shifts down to the right.
 - C) The LM curve shifts up to the left and income decreases.
 - D) The LM curve shifts up to the left and the IS curve shifts down to the left.
 - E) The LM curve shifts down to the right and income increases.
2. In a fixed-price model of a closed economy, a \$1 billion increase in government infrastructure expenditure will have the largest impact on the rate of interest when it is financed by
 - A) borrowing from the private sector.
 - B) borrowing from the central bank.
 - C) cutting other expenditure programs.
 - D) raising income taxes to the rich.
 - E) raising income taxes to the middle class.
3. A policy of a balanced budget over the business cycle would
 - A) require increasing government expenditures when revenues are rising.
 - B) require increasing taxes when revenues are falling.
 - C) call for substantial government infrastructure investments in periods of economic boom.
 - D) allow for the implementation of countercyclical fiscal policies without affecting the level of the national debt.
 - E) allow for the implementation of countercyclical fiscal policies without affecting the debt-to-GDP ratio.

Use this space for rough work.

4. Suppose that average income per capita in Uruguay is 300,000 pesos per year and that the nominal exchange rate for Uruguayan pesos is 0.04. Further suppose that a given consumption basket of goods and services costs \$2,500 in the Canada and 50,000 pesos in Uruguay. Using the Purchasing Power Parity exchange rate (e_{PPP}), what is the income per capita in Uruguay?
- A) \$12,000.
 - B) \$15,000.
 - C) \$18,000.
 - D) \$20,000.
 - E) None of the above.
5. In a flexible exchange rate system with perfect capital mobility, which one of the following statements is correct?
- A) Expansionary monetary policy will appreciate the domestic currency.
 - B) Fiscal expansion will be very effective in increasing equilibrium income.
 - C) Fiscal expansion causes an appreciation of the domestic currency.
 - D) An increase in exogenous exports will increase net exports.
 - E) None of the above is correct.
6. Consider the IS-LM framework in a fixed-price model of a closed economy. An increase in the rate of interest will cause
- A) the IS curve to shift up to the right.
 - B) the IS curve to shift down to the left.
 - C) the LM curve to shift up to the left.
 - D) the LM curve to shift down to the right.
 - E) none of the above.
7. If capital mobility is imperfect and import demand is completely insensitive to changes in the level of domestic income, which one of the following statements is correct?
- A) The BP curve is vertical.
 - B) The BP curve is downward sloping.
 - C) The BP curve is upward sloping if the international rate of interest is greater than the domestic rate of interest.
 - D) The BP curve is horizontal.
 - E) The BP curve is not determinable.
8. Suppose that the assets market is in equilibrium and that money and bonds are the only assets in the economy. If households and businesses increase their demand for real balances, which of the following best describes the final outcome?
- A) Both money holdings and bond holdings remain unchanged.
 - B) Money holdings decrease and bond holdings increase by the same amount.
 - C) Money holdings increase and bond holdings decrease by the same amount.
 - D) Both bond holdings and money holdings decrease by the same amount.
 - E) Bond holdings decrease but money holdings remain unchanged.

Use this space for rough work.

9. Suppose the government has a balanced budget and the money multiplier is equal to 2. If the government now finances a new expenditure of \$1.5 billion by selling bonds to the TD Bank, by how much will the money supply increase?
- A) \$0.75 billion.
 - B) \$1.5 billion.
 - C) \$3 billion.
 - D) By more than \$1.5 billion but less than \$3 billion.
 - E) None of the above is correct.
10. Assume that the desired currency-deposit ratio is 0.20, the desired reserve-deposit ratio is 0.10, and total money supply is \$4.8 billion. What is the amount of high-powered money if there are no excess reserves in the banking system?
- A) \$0.9 billion.
 - B) \$1.0 billion.
 - C) \$1.2 billion.
 - D) \$1.6 billion.
 - E) None of the above is correct.
11. Suppose the Bank of Canada makes an open market purchase of \$100 million, buys \$50 million worth of euros and US dollars in the exchange market, and spends \$75 million renovating the Bank's headquarter in Ottawa. As a result of these transactions, by how much will the monetary base increase?
- A) \$100 million.
 - B) \$150 million.
 - C) \$175 million.
 - D) \$225 million.
 - E) Need to know the money multiplier to answer.
12. Last year, Germany's trade surplus stood at almost \$300 billion and its current-account surplus was in excess of 8% of GDP. Of course, a current-account surplus implies that national savings exceed investment expenditure. Which one of the following is NOT an explanatory factor of Germany's current account imbalance?
- A) The German government is running budget surpluses, thus contributing to high national savings.
 - B) German households are saving too much, thus contributing to high national savings.
 - C) Wage increases have not kept pace with productivity growth, thus allowing business savings to rise too much.
 - D) A business-labour union accord has restrained wage increases and kept export industries competitive.
 - E) Sharing a common currency with other European countries allows Germany to have an undervalued currency in real terms.

Use this space for rough work.

PART II (10 marks)

Consider an open economy with a fixed price level, flexible exchange rates, and imperfect capital mobility. This economy is characterized by the following behavioural equations:

$$C = 200 - 10i + 0.8YD$$

$$I = 100 - 10i + 0.1Y$$

$$G = 400$$

$$TA = 0.25Y$$

$$TR = 0$$

$$X = 200 + 150e$$

$$Q = 300 - 50e + 0.1Y$$

$$CF = 25(i - 8)$$

$$L = 0.2Y - 10i$$

$$M/P = 200$$

- a) What is the equation for the *IS* curve in this model? (2 marks)

- b) What is the equation for the *LM* curve in this model? (1 mark)

c) What is the equation for the BP curve in this model? **(1 mark)**

d) What are the equilibrium values of Y , i and e ? **(6 marks)**

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PART III (40 marks)

Instructions: Answer the following four questions in the space provided. Each question is worth 10 marks.

1. **Critically comment on the following statement:** *“Some economists consider fiscal austerity to be the best strategy to restore growth and employment. According to this view, reducing public debt decreases interest rates and injects confidence in the private sector, freeing the basic instincts to invest and consume.”* **(Consider a closed economy and assume that there is a recessionary gap at the initial equilibrium.)**

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2. **Critically evaluate the following statement:** *“A decrease in Canada’s autonomous exports will cause the level of equilibrium income to fall, the rate of interest to rise, and the balances in both the current and the capital accounts to deteriorate.”* **(Show your answer with the help of a diagram and explain the economics. Consider an open economy characterized by a fixed-price level, fixed exchange rate, and imperfect capital mobility.)**

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3. **Critically evaluate the following statement:** *“A devaluation of the domestic currency will cause the level of income to increase, the rate of interest to fall, the balance in the current account to improve, and the balance in the capital account to deteriorate.”* **(Show your answer with the help of a diagram and explain the economics. Consider an open economy characterized by a fixed-price level, fixed exchange rates and imperfect capital mobility. Assume that there is a recessionary gap at the initial equilibrium.)**

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4. **Critically evaluate the following statement:** *“An increase in the international rate of interest will cause the equilibrium income of a small economy to fall, its rate of interest to increase, the balance in its current account to improve, and the balance in its capital account to deteriorate.”* **Show your answer with the help of a diagram and explain the economics. Consider an economy characterized by a fixed-price level, a flexible exchange rate, and imperfect capital mobility. Assume a recessionary gap and external balance at the initial equilibrium.**

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